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Abu Girma Moges
ABU_GIRMA@HOTMAIL.COM

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An Economic Analysis of Fiscal Federalism in Ethiopia

Abu Girma Moges^{*}

Abstract: *Fiscal federalism is a process of redistribution of fiscal decision-making power in an effort to improve the performance of the public sector in resource mobilization, efficient resource allocation and in the process enabling the economy achieve fast and sustainable economic growth. This paper addresses the economic rationale, implications and concerns of pursuing fiscal federalism in a poor country and in a political environment of ethnic federalism. The main findings suggest that when fiscal decentralization is exercised with high horizontal and vertical imbalances, it fails to diversify public output in line with the preferences and priorities of local population and to internalize the decisions of regional governments within their own jurisdictions. This in turn encourages the prevalence of big and yet weak government that extracts resources and fails to allocate for the purpose of sustainable and shared economic growth.*

Key Concepts: *Fiscal federalism, vertical and horizontal imbalances, federal grants, ethnic federalism, economic growth, poverty.*

JEL Classification: E62, H11, H71

1. Introduction

A growing number of countries have adopted fiscal federalism in an effort to improve the performance of their public sector. The underlying theme of the reforms is restructuring the public sector and improving its efficiency. In the context of fiscal policy, the reforms entailed decisions in identifying the optimal distribution of functions and powers between the federal and sub-national governments. This process introduces specialization of functions and changing the very relationship between the government and the citizen-voters in important ways.

Fiscal federalism can essentially be described as the choice and distribution of fiscal decision-making power across multi-leveled governments. The adoption of fiscal decentralization in most countries has taken a clear departure from their practice of centralized fiscal system within a unitary political regime. The failure of the centralized

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system of economic and political administration is one of the forces behind the temptation of a number of countries to experiment with the decentralization of both political and fiscal power (Tanzi, 1996). In some cases, fiscal decentralization followed the political imperative of establishing federal political structure. However, fiscal decentralization might involve significant economic cost and inefficiency in resource utilization when decentralization is exercised before local capacity is developed. After all, partial decentralization may not necessarily bring improved governance and accountability to the people at the grass root level that responds to local priorities and preferences.

Fiscal federalism in Ethiopia, the subject matter of this paper, has been adopted within a unique political landscape of ethnic federalism. The TPLF-led government that replaced the Dergue has redrawn the political map of the country and adopted ethnic based federal structure of government. This experiment has been formalized in the 1994 Constitution. However, the constitutional provisions operate with political centralism that has remained to be the distinguishing feature of the current political system.

The theme of this article is that fiscal federalism in the context of ethnic politics and de facto political centralization continue to hamper the realization of the economic potentials of the country and hence constrains efforts to address core economic problems. We address how and to what extent the policy and practice of fiscal federalism in the country has affected fiscal discipline, resource allocation, and efficiency of resource utilization as well as growth performance of sectors in the economy. The rest of the paper is organized as follows. The next section reviews the main strands of the theory of fiscal federalism and develops an economic argument on issues of fiscal federalism, section three reviews the fiscal system of Ethiopia and section four addresses the issues involved in the practice of fiscal federalism in Ethiopia and their implications on fiscal performance. The final section draws concluding remarks and highlights areas for policy actions.

2. The Theory of Fiscal Federalism

Federalism is a system in which the lower levels of government are represented in the central government and its institutions. Pursuing the federal structure involves both decentralization of decision-making power and representation of regional units at the national level. This process influences the allocation and distribution of economic

resources across regions and economic agents.

Fiscal federalism derives its nature and characteristics from constitutional provisions as well as the state of economic development, the pattern of income and resource distribution, and the institutional capacity of the system. The constitutional provisions define the framework within which decision-making would be exercised and establishes the vertical and horizontal structures that find meaning within the prevailing socio-economic environment of the system. The vertical structure defines the assignment of fiscal decision-making power between the federal and lower tiers of government. The horizontal structure outlines the nature of interaction across cross-sections of government levels. This aspect addresses how regional governments interact to each other especially when there are externalities and spillovers.

The main economic rationale behind fiscal decentralization is improving efficiency of public resource utilization, creating enabling environment for private sector development and the growth of the national economy. The theory of fiscal federalism addresses three issues related to fiscal decision-making: assignment of responsibilities and functions between the federal government and the regional governments, the assignment of taxation power and the design of inter-governmental transfer (subsidy) of fiscal resources coupled with provisions about the borrowing windows to sub-national governments. These factors give rise to a third issue of the relative size of the public sector in the national economy. It is therefore the dynamics of these processes and public policy choices that ultimately shapes the performance of the fiscal sector and its impact on the national economy.

2.1. Fiscal Function Assignment Issues

An important aspect of the exercise of fiscal federalism is the assignment of fiscal functions to the federal and the sub-national governments and the appropriate means of financing these responsibilities. The theory of fiscal federalism does not provide a clear-cut separation of fiscal responsibilities that would promote economic efficiency and resource distribution. The broad thrust of normative theory is that expenditure responsibilities in areas of macroeconomic stabilization and redistribution functions should remain within the domain of the federal government whereas allocation functions should be assigned to lower levels of government (Oates, 1999; Shah, 1999; Musgrave, 1983). The argument is based on the reasoning that lower levels

of government have limited capacity and policy instruments to provide stabilization and redistribution functions. Due to the nature of the responsibilities, the federal government usually assumes macroeconomic stabilization and income redistribution functions and make sure that regional governments would not take measures that are not compatible with such functions. Moreover, there are functions such as national defense and foreign affairs that have national public good character and hence usually assigned to the central government.

Fiscal decentralization and the assignment of functions can generate economic efficiency of the public sector. If preferences are heterogeneous across jurisdictions, which is most likely the case, decentralized decision-making power as to the provision of local public goods and services improves efficiency by tailoring services to the preferences of the local population. The main argument is that local governments are closer to the local population and can identify their choice and preferences better than the central government. Accordingly, when the decision to provide a bundle of public goods is made by local officials and these officials are directly accountable to the local voters, there is an incentive for the local public officials to provide services that reflect the preferences of the local population. Moreover, as long as there is close relation between the benefits from public services and taxes on the local taxpayers, there is additional incentive to utilize resources efficiently and cost effectively. At least by implication, the theory recognizes the need for local authorities to exercise choice in the provision of public services that are of higher local demand instead of resorting to the unitary solution. The decentralization theorem suggests that, under such conditions, decentralization of fiscal decision-making can improve efficiency of the public sector and the welfare of the local population.

Once the allocation of expenditure responsibilities is conducted according to such broad principles, the fiscal system needs to address the issue of assigning taxing power that broadly identifies who should tax, where and what (Musgrave, 1983). The imposition of taxes, in the absence of lump-sum source of taxation, always involves a certain degree of economic inefficiency. In the context of fiscal federalism, the assignment process needs to identify the comparative efficiency and effectiveness of providing the fiscal instruments to the multi-tier decision-making centers so as to finance public functions and activities in the most efficient manner possible.

What kind of taxes should be assigned to the federal government and which should be assigned to the local governments? The theory and practice in the assignment

of taxation power identifies the following main criteria in assignment process: taxes on mobile tax bases, redistributive taxes, taxes that could easily be exported to other jurisdictions, taxes on unevenly distributed tax bases, taxes that have large cyclical fluctuations, and taxes that involve considerable economies of scale in tax administration should be assigned to the national or federal government (Sobel, 1997; Musgrave, 1983; Tanzi and Zee, 2000, Oates, 1996). There are efficiency and equity considerations behind such principle of tax assignment.

The assignment of taxing power between the federal and the regional governments and the provision for concurrent power to share establishes the basic link in which the behavior of one of the parties would influence the decision making power of the other and its effective tax base. There is a possibility for vertical tax externality that might require additional policy instruments to correct their effect on other levels of government (Keen, 1998). When there are clear cases in which vertical tax externalities are prevalent, the tension between the federal and the state governments would arise. This in turn would require mechanisms for the assignment of taxing power and revenue based on the nature and characteristics of the tax base.

The assignment of taxing power is a thorny issue in fiscal policy and its application is influenced by a number of considerations. First, despite the legislative assignment of taxes, the actual potency of the tax network depends on the nature and development of the national economy, the relative distribution of economic activities across jurisdictions, and the administrative efficiency of the taxation system. Second, the practice of fiscal federalism, especially when citizens across regions with diverse economic and demographic situations are treated unequally, gives rise to the violation of one of the core principles of horizontal fiscal equity. Moreover, fiscal decentralization might also potentially breach the principle of vertical fiscal equity by not treating taxpayers with different capacity to pay differently. Third, despite the monopoly of taxing power resides at the disposal of the government, the reach of the taxation network depends on the economic circumstances of the potential taxpayers.

2.2. Fiscal Imbalances and Intergovernmental Transfers

The distribution of the tax base and the demand for public goods and services does not follow symmetrical pattern and this gives rise to the emergence of fiscal imbalances. A number of reasons, both economic and social, contribute to the mismatch

between the expenditure responsibilities and the capacity of the lower levels of government to raise sufficient revenue to finance their expenditure. Vertical fiscal imbalances are the result of allocation of functions the cost of provision of which is higher than the sources of revenue assigned to local governments. This indicates the case in which the level of revenue source decentralization is lower than the decentralization of expenditure responsibilities. Horizontal fiscal imbalance emerges usually as a result of concentration of tax bases due to uneven distribution of economic resources and economic activity across regions whereas expenditure requirements are spread more evenly.

The problems of fiscal imbalances require measures that include the provision of subsidies as well as policies that promote balanced growth of regional economies. The process of changing the taxation base of regional economies is slow and requires consistent policies that address the underlying sources of inequalities across regional economies. Inter-governmental transfers or grant systems, however, might generate their own problems of the commons. When vertical fiscal imbalance is significant and local governments depend excessively on the federal fiscal grants, their fiscal autonomy would be compromised. Moreover, local government officials and the population would have the incentive to maximize their federal grant receipts as long as they do not proportionately share the burden of taxation. Where local governments do not bear the cost of their spending decisions, there are incentives for local governments to expand their budget beyond their means and this behavior is prevalent when the benefits are concentrated whereas the cost of financing such benefits is drawn from the common pool.

Inter-governmental fiscal transfers involve two main decisions even if most federal systems pursue different approaches. The federal government needs to decide on the aggregate pool of federal grants and then the pool has to be distributed among the respective lower sub-national governments. The federal government can decide on the size of the federal grant pool based on certain parameters or on some ad hoc mechanisms. Once the pool of federal grants is decided, the distribution of such grants across regions or local levels of government follows a number of possibilities. The federal government may exercise discretionary decisions to distribute such resources. However, the risk of such discretionary exercise is that allocation might be influenced by political considerations instead of real need for assistance at the local levels. The most conventional way is the use of some grant distribution formula that takes into

account indicators of needs and other factors at the sub-national government levels.

2.3. Decentralization and the size of the government

The appropriate role and relative size of government in national economies are controversial political economy issues. The actual size of government in national economies is influenced by a number of economic, social, and political factors (Lowery and Berry, 1987; Rodrik, 1996). The normative argument about the proper size of government is also influenced by a wave of development thinking of the day.

One distinctive feature of the issue, however, has been the phenomenal shift in policy thinking about the role of the government in economic development. In much of the first half of the 20th Century, government was considered the main force to bring about economic development and transformation especially in the underdeveloped countries. This line of thinking was confronted with criticism when government failure became pervasive. By the 1980s, the widely held view among global policy makers and academics was that big government was the problem rather than the solution in the effort of countries to bring about economic development. Accordingly, the 1980s and 1990s witnessed policy prescriptions that attempted to reduce the size of the government in national economies.

In the current post-Washington-Consensus era, the pendulum of policy thinking seems swinging with a more pragmatic tone. The prevailing argument is that smart and strong government and market forces can have a dynamically changing relation in which developmental governments play a critical role in investment, human capital formation, technology promotion, and institutional building without hampering the forces of the market in the system.

Does fiscal decentralization have influence on the size of the government? The relation between fiscal decentralization and the relative size of the public sector in national economies is not clearly established (Ehadie, 1994; Grossman, 1989). The public finance theory identifies forces that shape the extent of government intervention in a national economy. These forces include market failure, imperfect information, incomplete market, externalities, public goods and significant unemployment of resources. The extent to which these forces prevail in a system influences and shapes the relative size of government intervention in the economy. The possible impact of the

process of fiscal decentralization on the overall size of the public sector is moderated through a number of factors such as the political institutions, the extent to which the cost of providing public services is internalized at local levels, ideological position of the government in power, and the autonomy of local governments.

As we argued earlier, the process of fiscal decentralization can potentially improve efficiency in the provision of public goods by identifying the preferences of local population and internalize the cost within the same jurisdiction. When political institutions enforce accountability and local officials are responsible to the local constituency, there is incentive for decision makers to achieve goals that are in line with the preferences of the local population. The internalization of the cost of public service provision would provide extra incentive to discipline fiscal decisions and operate within hard budget constraint. If the expenditure choice of local governments is linked to taxation on the local population, there would be strong reason to maintain fiscal discipline and operate towards a smaller and efficient government size. However, as long as the benefits from provision of local public services accrue to those who are not paying for the cost of such provisions, there is a tendency for excessive demand and increase in the size of the government. This might lead to the expansion of the public sector without a correspondingly positive effect on the performance of the national economy.

3. Features of the Ethiopian Fiscal System

The fiscal system of Ethiopia has historically been characterized by high centralization and concentration of fiscal decision-making power at the center. Moreover, the structure of the fiscal system shares important features with other underdeveloped economies in terms of reliance on indirect taxes, dependency on international trade taxes, and persistent fiscal deficits.

The current fiscal system of Ethiopia features some departures from the previous systems and striking continuities in the structure and essential elements of fiscal performance of the economy. Table 1 summarizes the main features of fiscal aggregates of Ethiopia. These attributes suggest that either the government is not willing to fundamentally change its fiscal policy stance or the fiscal system is governed by the structural features of the economy that are not easily amenable to change in response to fiscal policy reforms. A closer examination of the main features of the fiscal system

suggests that both factors play a role in the process. The nature and structure of the economy, the resulting tax bases, the excessive dependence on international trade taxes and external grants, and persistent deficits all contribute to the prevailing features of the fiscal sector as do the fiscal policy stance of the government.

**Table1- Ethiopia: The Structure of Government Revenue and Expenditure
1980/1 – 2001/02 (As a percentage of GDP)**

Period	Tax	Non-Tax	External Grants	Recurrent	Capital	Deficit before Grants
1980/1-1983/4	14.00	4.60	2.21	19.39	7.70	-8.48
1984/5-1985/6	13.35	5.90	4.06	19.66	9.98	-10.38
1986/7-1990/1	13.72	6.48	3.27	22.02	9.24	-11.05
1991/2-1994/5	9.59	3.89	2.80	14.86	7.52	-8.90
1995/6-1997/8	12.39	6.30	3.04	14.87	9.24	-6.42
1998/9-2001/02	13.27	6.59	4.04	22.21	9.54	-12.37
1980/1-1990/1	13.76	5.69	3.03	20.63	8.81	-9.99
1991/2-2001/2	11.69	5.53	3.31	17.54	8.73	-9.48
1980/1-2001/2	12.72	5.61	3.17	19.08	8.77	-9.74

Source: computed from Ministry of Finance and Economic Development data sources

For the period 1980/81-2001/02, the government on average extracted about 18 percent of GDP from the public and spent about 28 percent of GDP, of which recurrent spending took more than 19 percent and only 9 percent left for capital spending. This behavior of excessive spending left an average fiscal gap of about 10 percent. Foreigners provided about 3 percent as charity and lent about 4 percent of GDP and the rest was financed mainly from domestic banking system. A fiscal system that resorts to borrowing to cover about 36 percent of its spending appetite would sooner or later confront the consequence of its behavior. It is an important predictor of a looming crisis. This behavior of fiscal spending also affected the macroeconomic situation in which aggregate expenditure run in excess of domestic production. The country has become increasingly dependent on foreign aid and borrowing to finance its consumption and investment expenditure.

The fiscal system, nonetheless, witnessed important changes over time. Government revenue increased during the 1980s and reached a pick of 24.8 percent of GDP in 1988/89 before it declined drastically during the subsequent two years of political turmoil in the country. The fiscal regime was extremely coercive and led to distortions in resource allocation. The prohibitively high marginal tax rate had driven

most activities underground and tax evasion and corruption were on the rise. Such a system was indeed unsustainable and the change in the political regime precipitates a collapse in the fiscal system. The decline in revenue was particularly severe from business profit taxes, export taxes and revenue from government investment income. The collection of government revenue collapsed from about a quarter of GDP to about 10.6 percent by 1991/92.

The transitional government introduced a number of fiscal and monetary policy reforms that had mixed implications on the revenue collection. The amendment in the tax codes, devaluation and gradual depreciation of the exchange rate, elimination of taxes on exports (except coffee duties), and the privatization process have had important implications on the amount and structure of government revenue. The average domestic revenue to GDP ratio has recovered gradually and for the period 1991/92 to 2001/02 the average reached about 17.2 percent with a gradual and yet increasing trend. The average tax revenue for the period was about 11.7 percent of GDP.

One typical feature of the tax structure is its narrow base. There is an increasing dependency on foreign trade, especially import, taxes in recent years. The devaluation of the currency and its subsequent depreciation over time somewhat expanded the domestic currency denominated tax base on imports. As figure 1 depicts, the shift in the composition of tax revenue was significant and such a trend brings its own problems to fiscal management and planning besides its possible effects on the macroeconomic stability of the economy and sectors with higher intensity of imports.

The overall share of tax revenue to GDP is small both in absolute terms as well as relative to the average for developing countries. The tax revenue-to-GDP ratio for developing countries is about 18 percent and for African countries is about 20 percent. The ratio of tax revenue in GDP for advanced countries is significantly higher than developing countries, at about 38 percent, reflecting the state of economic development, the tax base and the efficiency of tax administration (Tanzi and Zee, 2000; Rodrik, 1996). This pattern could broadly be attributable to the structure and performance of the economy, the administration of the taxation system, and the design of the taxation system.

A longer view of the fiscal resource allocation behavior of the government, despite marginal changes in some aspects of the fiscal components, suggests that there

has not been enduring and significant shift in policy over the past two or so decades. The current government in power, except some marginal changes, shares important characteristics and behavior in fiscal policy with its predecessor. The current regime spends about 26 percent of GDP and extracts from the public about 17 percent of GDP. Foreigners still provide about 3 percent as grants and lend about 3.7 percent of GDP. The remainder of about 2.4 percent of GDP has been financed from domestic borrowing. The relative performance of the current fiscal regime shows some improvement and yet it still covers about 23 percent of its spending by borrowing.

The result of such features of government revenue and expenditure has been the emergence of persistent fiscal deficits and the accumulation of public debt. Domestic government revenue apparently has been barely enough to cover recurrent government expenditure let alone to generate resources for financing capital expenditure. The level of deficit has increased so much so that in recent years it has been as much as the total tax revenue collection of the government. Such a stance of fiscal policy is unsustainable and the external grants, even if important to partially narrow the gap, would not and could not resolve the problem. The government has increased its appetite for borrowing from foreign sources to bridge the gap and when external borrowing does not satisfy it resorts quite easily to borrow from the domestic banking sector.

The fiscal performance of the country is reflections of a typical underdeveloped and agrarian based economy in which the majority of the population lives in chronic poverty and a government that devotes its effort to extraction of resources from the economy and failing to allocate these resources to priority areas and sectors of the economy. When this is coupled with a de facto fiscal centralization and stance of inefficient public resource allocation, it fails to address the priorities of the majority of the population and hence becomes increasingly unsustainable. However, both political imperatives and changes in the overall economic policy of the country opened the door for fiscal policy innovation. We will address this issue in the next section and assess the context in which fiscal federalism is being implemented in the country.

4. Fiscal Federalism within Ethnic Federalism

Fiscal federalism operates within the political and administrative framework of

a system. Fiscal decentralization is a process and a continuum of degrees. Even centralized political and fiscal systems, to a certain degree, exercise administrative delegation of fiscal responsibilities. For a country with an initially unitary system of government, reforms towards fiscal federalism entail devolution of decision making power from the center to lower levels of government.

The policy of fiscal federalism has been put place in Ethiopia within a unique political and economic environment. The overthrow of the military regime of Ethiopia in 1991 by a coalition of rebel forces set the stage for a drastic shift in the political landscape of the country. Most of the rebel groups, at least the dominant ones, were formed as liberation fronts of an ethnic group or region. These groups had inbuilt motivation of their movements, derived from their ideological backgrounds and anchored on their interpretation of addressing ethnic problems. The TPLF regime seized power and created shadow political organizations after its own image and made effective use of such political effigies to concentrate political power and effectively forming a quasi-one party system in the guise of federalism.

During the transition period, 1991-1995, the transitional Charter was designed to conduct political experiment of reorganization of the country along ethno-linguistic lines. The Charter and subsequent proclamations (proclamation No. 7/1992, Proclamation No. 43/1993) redrawn the political map of the country, established regional self-governments, promulgated laws to the establishment of a central transitional government and the regional self-governments, and provided division of political power between the central and regional governments. Moreover, a scheme that defines the expenditure responsibilities of the central government and the regional governments and the corresponding sources of revenue was defined (Proclamation No. 33/1992).

The process culminated in the formalization of the ethnic-territorial federal structure of government with the adoption of the Constitution of the Federal Democratic Republic of Ethiopia in 1994. The Constitution formalized the experiment of ethno-linguistic based structure of government into a federal structure. The Constitution proclaims a parliamentary democracy with bicameral chambers at the federal level and a chamber parliament at the regional level. The House of Peoples Representatives and the House of Federation constitute the federal parliament whereas the State Councils represent the parliament at regional level.

Federalism operates by ensuring equitable (proportional) representation of sub-national units in the federal government. One of the core pillars of the Constitution is that it vests supreme power in the hands of nations, nationalities and peoples of Ethiopia. This translates into the formation of regional states that have equal horizontal power. The Constitution hence violates equality of all Ethiopians in their representation both at regional and federal levels of government. Moreover, the process of its framing, the participation process in its design, flexibility for amendment when compelling rationale emerges remain contentious issues in the discussion of the Ethiopian Constitution. These features have implications both in the legislative and executive branches of government and hence on the effectiveness of the federal solution to countries with diverse socio-economic conditions.

The Ethiopian federal structure consists of nine regional states and two chartered city administrations. The regional states are further divided into Zones and Woredas creating a four-tier level of government. In effect, there are 11 regions, 66 zones, 550 Woredas and 6 special Woredas under the new arrangement. The Woreda serves as the basic unit of administration in the framework. The devolution process is still in progress and is evolving and has not yet widely reached the local levels of government. The capacity to design and execute policies at the local level is quite weak and for all practical purposes, the Ethiopian federal system has a two-tier level of government structure.

The Constitution divides responsibilities under the jurisdictions of the federal government and the regional governments. Responsibilities for the federal government include defense, public security and order, international relations, citizenship and immigration, international and inter-state trade, fiscal and monetary policies, currency, banking and domestic borrowing by states (Proc. No. 1/1995).

The Constitution provides extensive decision-making legislative and executive powers and responsibilities to the regional states. The most notable ones are: enactment of state constitution and laws; formulation and execution of economic, social and development policies, strategies and plans; administration of land and other natural resources in the territory; levy and collection of taxes assigned to the regional states; designing standards for state level civil services and payment; and maintenance of state level security forces. The Constitution reserves all powers not provided to the federal

government to the regional governments.

The Constitution, unlike the Charter, provides power to regional governments and does not impose subordination of their rights to the federal government. This constitutional provision hence provides strong discretion to regional governments in several areas of decision-making. However, the regional governments have incentives to comply with the policies of the federal government as long as they are financially and politically dependent on the center. Moreover, there are parallel power structures that are established by the TPLF group which keeps the regional administrations within a highly centralized structure of control. Though unconstitutional, the nominal independence of the regional governments and officials are restricted by both economic and political imperatives.

It is within this framework of ethnic federal structure of government that the economic and fiscal policies of the country are being exercised. What are the implications of such changes in the political and policy environment in terms of the design and implementation of fiscal policy in the country? We explore the implications such constitutional provisions on the fiscal system and policy of the country and the sustainability and compatibility of such policies with the objectives of bringing about fast and shared economic growth, social transformation, and improvement in the standard of living of the population.

4.1. Fiscal Policy Implications

Fiscal federalism in Ethiopia has been put in place within the dictates of political imperatives. The exercise has reshaped the economic and political landscape of the country. One of the effects of the redrawing of the political map of the country is forming extremely heterogeneous economic regions. Unlike a system in which resources can easily flow across regions, the ethnic based political boundary establishes administrative, institutional and political restrictions for a full realization of the economic potentials of the country. When ethnic affiliation comes to influence how economic and political decisions are made, the economic implication is that agents would be bound to operate within certain regions than others. There are political risks that one has to assume in investing in other regional states.

The federal structure of Ethiopia carved regional states that exhibit significant

variations and heterogeneity. These diverse circumstances of regional states gave rise to horizontal fiscal imbalances. The regional distribution of revenue sources is such that it leaves most of the regional states with revenue flows far short of their expenditure responsibilities. The most potent sources of fiscal revenue are concentrated under the authority of the federal government and regional states collect revenues that could not cover their expenditures. For the period 1993/4 – 2000/01, the regional states as a group managed to finance on average only about 33.8 percent of their expenditure depending for about two-third of their expenditure requirements on federal subsidies. This level of dependency on the federal government constrains the fiscal choices of regional governments.

One of the important issues related with the adoption of fiscal federalism is the extent to which it has enabled regional states to tailor their fiscal resources to the needs and priorities of the local population. Have they managed to identify their local preferences of public goods and reflect them in the budgetary allocations? Has the overall fiscal resource allocation of the country been geared towards the promotion of economic growth, improved distribution of opportunities and the reduction of poverty? These are some of the economic issues that are closely related to the exercise of fiscal federalism.

The Constitution and related laws provide the framework for the assignment of revenues and expenditure responsibilities between the federal government and the regional governments. The Constitution defines the powers and responsibilities of the federal government that broadly include areas that have national public goods character. It does not, however, explicitly define the expenditure responsibilities of regional governments. And yet, it provides that what is not defined as federal powers and responsibilities is provided for regional governments. This suggests that regional governments have responsibilities that are critical in the provision of public services that influence standard of living in the regional economies such as poverty reduction policies, the provision of health and education services, the provision of core regional infrastructure, the promotion of investment and growth in the regional economies.

The Ethiopian Constitution defines the assignment of tax and non-tax revenue sources to the regional and the federal governments (Proclamation No. 1/1995: Art. 96, 97, 98). This assignment provides exclusive right for the federal government to tax international trade and the dominant share of domestic indirect taxes. These two sources

have on average a combined share of about 64 percent of the tax base for period 1991/2 to 2001/02. Hence, the most potent source of tax revenue is assigned to the federal government. The regional governments are assigned with the collection of direct taxes within their jurisdictions, land use fees, and taxes on a subsistence based farm households. Moreover, the federal government collects payroll, sales taxes and non-tax revenues from public enterprises owned by the federal government irrespective of their location across the country. In this sense, regional governments could not generate revenue from such enterprises located within their jurisdictions. The tax base of regional governments generates relatively meager revenues and is relatively stagnant with a property of low buoyancy. The situation is more or less similar with respect to non-tax revenue sources in which the federal government collects about 80 percent of non-tax revenue of the fiscal system. The combined regional share of revenue collection has remained within a narrow range of 18 to 20 percent of total revenue.

The state and distribution of economic activities across the country has exerted its influence not only the overall revenue mobilization effort of the government but also on the regional distribution of revenue in the new framework of fiscal federalism. The fiscal implications of such patterns of distribution of economic activities are that the fiscal viability of regional states is highly dependent on the extent to which they manage to spur growth and economic transformation in their regions. This requires not only pursuing policies in pursuant to national policies but also engaging in activities that focus on the comparative advantage of regional economies and developing strategies. The potential advantage of the federal solution to fiscal decision-making emerges not only in the allocation of public resources but also by the degree to which it promotes the efficient allocation of economic resources and activities across regions. Without proper balancing of these two forces, the economic gains generated in one process might be compromised by the adverse effects of other processes.

The concentration of government revenue at the disposal of the federal government relative to regional governments is accompanied by concentration of revenue mobilization capacity across regions. Relatively prosperous city administrations coexist with extremely poor and fiscally and economically dependent regions. Table 2 depicts the summary of horizontal fiscal imbalances in the country. It exhibits considerable variation across regions. Even regions with considerable own-revenue generating capacity, such as Addis Ababa city administration, have problems providing basic services to all of its constituents. The horizontal fiscal imbalances,

perhaps viewed in combination with imputed tax base of regions, could provide an even better picture to assess how to address priority problems in the regions.

Table 2: Ethiopia: Elements of Regional Horizontal Imbalances

Characteristics/ Regional Governments	Population Share (%)	Area Share (%)	Own-Revenue per capita (Birr) 2000-01	Poverty Index 1999/00	Regional Fiscal Imbalance (%)2000-01
Gambela	0.35	2.40	35.6	0.51	5.4
Afar	2.03	7.07	12.7	0.56	6.36
Benisha-Gumuz	0.88	4.30	24.2	0.54	7.15
Somali	3.55	19.82	8.2	0.38	8.31
Harari	0.26	0.03	54.0	0.26	12.04
SNNPRs	19.84	10.28	11.5	0.51	16.38
Amhara	26.48	17.34	11.3	0.42	17.36
Tigray	6.02	5.53	20.8	0.61	18.39
Oromiya	35.89	33.05	15.2	0.40	20.91
Dire Dawa	0.50	0.15	71.7	0.33	37.66
Addis Ababa	4.02	0.04	409.5	0.36	79.27
Ethiopia/Regions	100.00	100.0	13.8	0.44	46.11

Note: The regional governments are ranked by the degree of their fiscal imbalance during 2000/01. Despite data problem and issues, the correlation between the headcount poverty index and fiscal independence is weak (-0.3853). Population density turns out to have a high correlation with fiscal independence index (0.9085) and own per capita revenue (0.9907) perhaps due to urbanization, agglomeration and tax administration effects. The correlation between regional poverty and per capita public expenditure is rather weak (-0.1546).

Sources: Ministry of Finance and Economic Development; FDRE (2002); World Bank, 2001.

The issue touches three important elements in the current fiscal policy of the country. First, the federal government needs to reconsider its fiscal policy and facilitate directly the provision of basic public services to all households irrespective of their residence across regions instead of just leaving the matter to financially dependent regional governments. This is justified on the ground that even in Addis Ababa and Dire Dawa, where the own revenue is relatively high, about a third of their population live under the national absolute poverty line with limited access to basic public services. Second, if the current arrangement is to continue, it is imperative that in the allocation formula of federal grants, proper weighting is attached to the actual contribution of regions to the tax base of the revenues of the federal government. The third alternative might involve changing the relative weight of federal grants distribution in favor of poverty indicators.

Table 3: Vertical Fiscal Imbalances in Ethiopia [1993/94 – 2000/01]

Category/ Year	Combined regions' share of revenue (%)	Combined regions' share of expenditure (%)	Vertical Imbalance*
1993/94	17.8	34.5	0.4841
1994/95	15.4	38.3	0.5979
1995/96	16.6	41.2	0.5971
1996/97	18.0	42.5	0.5765
1997/98	19.7	39.6	0.5025
1998/99	18.0	30.5	0.4098
1999/00	18.3	23.3	0.2146
2000/01	18.0	33.4	0.4611
1993/4-2000/01	17.7	35.4	0.4804

Note: *-The vertical Imbalance index is computed as: $VI = \{1 - [(R^R/R)/(E^R/E)]\}$ where R^R is combined revenue of regions and R is the consolidated revenue of the government, E^R measures the amount of combined expenditure of regions whereas E measures the total (federal plus regional governments) expenditure.

Source: Computed based on data from Ministry of Finance and Economic Development

The assignment of revenue sources and expenditure responsibilities between the federal government and the regional governments is such that almost all of the regional governments can generate own revenue that can cover only part of their expenditure requirements. This mismatch between revenue generating capacity of regions and their expenditure responsibility has given rise to the problem of vertical fiscal imbalances. As table 3 depicts, the regional governments have a combined expenditure responsibility of about 35 percent of total consolidated government expenditure whereas their share of own revenue was just about 18 percent. This is a clear indication of situation where revenue decentralization is smaller than expenditure decentralization the apparent consequence of which is the emergence of vertical fiscal imbalance.

The extent of vertical fiscal imbalance in Ethiopia is quite high. The dependence of regional governments on the federal grants is so significant that without federal grants most of the regions could not even cover their recurrent expenditures. It is therefore clear that the fiscal policy stance of the federal government directly affects the policy choice variables at the regional levels despite the nominal fiscal autonomy that the regional governments seem to exercise.

4.2. Federal Grants and Intergovernmental Transfer Issues

Fiscal imbalances emerge from the interactions of fiscal policy stance, distribution of the tax base, and the state and distribution of economic development across the country. The government has put in place mechanisms to subsidize the fiscal short-falls of regional governments. The magnitude and distribution of such federal subsidies poses two political economic problems: deciding the aggregate amount of federal subsidies from the total purse of the federal government and distributing this amount across regional governments.

The Constitution, as well as the various laws related to fiscal policy, does not specify the absolute or relative magnitude of aggregate budgetary grants pool for the federal grant. The Constitution, (Article 90), states a general principle in which, given the resource constraints, policies shall be aimed to provide all Ethiopians access to health and education, clean water, housing, food and social security. The actual execution of such principle has been constrained by the budgetary allocation preference of the federal government. The practice is that the federal government develops an envelope public expenditure budget. The allocation of funds between the federal and the regional governments has been made on an ad hoc basis combining budget requests from regions and the budgetary preferences and allocation decisions of the federal government. This makes the pool of the federal grant somewhat unpredictable from the perspective of regional governments.

Once the pool of federal grants is determined in such a manner, with some offset adjustment for expected external aid and grants to regional governments, the federal government provides unconditional block grants according to a grant formula. The regional governments have the discretion as to detailed allocation and management of such federal grants. In recent years, the federal government on average provided subsidies to regions to the extent of about 36 percent of the consolidated government revenue and external grants. This pool of the federal grants is the most important determinant of the actual amount of resources at the disposal of regional governments.

To address this problem of fiscal imbalance, the federal government has used grant formula to distribute federal grants that take into account a composite of several indicative variables. These variables include population, composite index of level of development, sector performance and recently an index of poverty situation in the respective regions. The grant distribution formula has been frequently adjusted to improve fair distribution of resources and encouraging efficiency and effort of regional governments to mobilize resources from local sources.

The initial phase of the process followed an ad hoc procedure of grant distribution. Since 1994, however, the federal government has adopted the more conventional approach and relatively transparent distribution formula to determine the share of regional governments from the pool of federal grants. The initial phase of this practice provided equal weight for three indicators: population, level of development and revenue effort. This was changed in 1998 and in 2001 and it is currently under revision. Given the absolute and relative magnitude of the federal grants to the regional governments, it remains to be a typical political economy issue with potentials for conflict of interest between the federal government and regional governments as well as across regional governments.

A closer observation of the federal grant distribution formula, as summarized in table 4, reveals important issues. The relative weight of population of regions in the formulae increased from a third to 60 percent in 1998 and then reduced to 55 percent in 2001. Currently, there is a proposal to further change the relative weights in favor of population share. This would change the relative share of federal grants allocation across regions. The frequent changes in the formula suggest genuine effort to make the formula reflect the understated or omitted variables as far as more and reliable information is available. However, it is also a typical behavior of agents that attempt to maximize their share irrespective of what would happen to the rest of the constituents. This is how regional governments can externalize their expenditure decisions especially when there are rooms to generate resources without increasing taxes on the local population.

Table 4-Ethiopia: Relative Weights of Variables in the Federal Grant Formula

Variables	1994 Formula	1998 Formula	2001 Formula
1.Index of Population	33.33	60.0	55.0
2.Composite Inverted Index of development	33.33	25.0	20.0
3.Index of own revenue raising effort	33.33	15.0	15.0
4. Poverty Index	0.0	0.0	10.0

Source: Ministry of Finance and Economic Development

The current distribution of federal grants attaches higher weight to population share of the regional states. The regional pattern of population distribution is so uneven that about 80 percent of the population lives in three regional states whose collective

share of federal subsidies is two-third of total federal grants. The other variable in the federal grant formula is a composite index of development that combines index of unit expenditure variable and sector indicators of development in areas such as education, health, road, and access to water. These are proxy indicators of the level of development variation across regions. The inverted level of development index has been assigned 20 percent weight since 2001. The third category of variables consists indicators of the effort of regional governments to increase own revenue from sources assigned to them and how these resources are used to improve budgetary performance. Own revenue raising efforts relative to regional income, adjusted to population share and revenue base, is given 73 percent whereas the remaining 27 percent is intended to capture how much budgetary allocation has improved basic services, such as primary school participation, rural road and health services, in the respective regions. This is an important element in the rationalization of public resource utilization and it has 15 percent relative weight in the distribution of federal grants.

Since 2001, the federal grant distribution formula has introduced the distribution of poverty across regions with a 10 percent weight to determine the share of regions in the total pool of federal grants. The introduction of this variable is an important development provided that reliable data could be generated to monitor the level and changes in poverty across regions. Since it measures directly the resource needs of regions to address such a critical problem in the system, the indicators of poverty as a gauge to distribute public resources and preferably to finance programs that would enable the poor have opportunities to escape chronic poverty on a sustainable basis would have important growth and fiscal implications.

Table 5: Ethiopia: Regional Share of Federal Grants (percentage share)

Year Regions	1993/4	1994/5	95/6-97/8	1998/9- 2000/01	2001/2	Average 1993/4- 2001/02
Tigray	10.58	11.39	9.52	7.61	6.39	8.86
Afar	4.92	3.29	4.88	6.85	6.17	5.51
Amhara	20.09	24.56	24.00	21.80	21.25	22.59
Oromiya	32.25	28.12	29.01	27.34	30.06	28.83
Somali	3.09	2.79	5.04	9.00	9.02	6.34
Benisha-Gumuz	3.29	1.47	3.86	4.76	4.40	3.89
SNNPRs	15.85	20.51	18.58	16.07	15.08	17.27
Gambella	2.77	2.46	2.54	3.97	3.64	3.16
Harari	0.83	1.33	1.69	1.76	1.71	1.58
Addis Ababa	6.27	3.94	0.38	0.01	0.00	1.26

Dire Dawa	0.06	0.13	0.63	0.82	2.27	0.76
Total Amount (Million Birr)	1950.1	2292.7	2866.1	3194.8	3339.9	2862.8

Source: Ministry of Finance and Economic Development

Table 5 summarizes the actual share in federal grants received by regional governments. The distribution pattern reveals that there are important variations in the share of regions. It is also important to note that despite the changes in the weights attached to the underlying variables, the actual share of regional states from the pool of the federal grant shows only marginal changes. It implies that the most important determinant of the actual amount of federal grants received by regional governments is the size of pool more than how it is distributed across regions. This critical power remains in the firm hands of the federal government.

One important practical issue in the distribution of federal grants is related to the treatment of planned foreign aid and assistance to regional governments either directly or through the federal government. The current practice is a compensation scheme in which federal grants are extended taking into account the full amount of foreign aid extended to the respective regional governments (World Bank, 2000, 2001). This practice appeals from the perspective of fair overall distribution of supplements to own revenue of regional governments. However, it can also have a side effect of discouraging foreign aid mobilization effort of regional government and by implication the concentration of foreign aid at the disposal of federal government. It is nonetheless plausible to provide regional governments the incentive to mobilize external grants that do not entail external debt servicing.

The problems of macroeconomic instability effects and the possible emergence of the problem of the commons make allowing regional governments borrowing from abroad a contentious proposition. This is particularly the case when the benefits from projects financed by such borrowing accrue to specific regions and yet the obligation to servicing external debt is shared by all regions, particularly foreign exchange earning regions. However, when it comes to external grants with no debt repayment obligations attached, there are important benefits to regions and their population. The concern of uneven distribution of such grants could well be compensated by the benefits that could be generated as a result of concerted effort on the side of regional governments to mobilize external resources for social and economic infrastructure and capacity building purposes.

The fact that resources are unevenly distributed and economic activities are concentrated across regions implies uneven distribution of revenue mobilization capacity of regions. This would in turn affect the capacity of regions to provide public services for the citizens under their jurisdictions. If the federal government is committed to the principle that at least a minimum level of public goods and services should be provided for every citizen irrespective of their location of residence, allocation of resources for such purposes through the federal grant mechanism would have important equity effects. In this context, it would be necessary to identify the minimum set of public services that every region should be able to provide irrespective of their actual capacity to generate own revenue. The minimum set, of course, is subject to variation depending on the actual level of development of the country and across regions.

The current practice uses the poverty index as a yardstick to distribute federal grants to regional governments. However, it falls short of ensuring how such funds are used to improve the poverty situation of the poor households in the country. It is important to establish a mechanism that would ensure such funds be directly used to create opportunities for the poor to escape poverty and in the worst cases to reduce the suffering of the poor from destitution. Despite the variations in the index of poverty across regions, it is clear that poverty is a nationally shared phenomenon that deserves to be the responsibility of the federal government. Given the importance that poverty targets have received in recent years both locally and internationally, it should be conceivable to generate enough economic and political support for such schemes to be implemented.

When the mismatch between the expenditure responsibility and the revenue assignment is so significant, the federal government retains the key power and influences decisions at the regional level. In areas of expenditure assignment, the federal government needs to take direct responsibility to create opportunities for poor households irrespective of their location in the country based on a set of threshold criteria. The current practice attempts to address the problem indirectly through the regional administration and it does not address the problem for several reasons. First, the regional governments receive unconditional block grants and their decision-making process might not directly and necessarily address the problems of extremely poor households in their jurisdiction. In a country where about 45 percent of the population lives in destitution, such indirect processes of budgetary assistance would hardly trickle down to the poor. Second, with such a level of vertical fiscal imbalances and most

regions are dependent on federal grants to carry out their expenditure responsibilities. It is therefore justifiable, both on equity and poverty reduction considerations, for the federal government to directly provide social security assistance to those poor households.

The practice of providing unconditional block federal grants to regional governments has important bearings on the fiscal management of regions and how resources would be channeled to lower levels of government. The federal grants do not address the intra-regions distribution of fiscal subsidies. Regional level of centralized decision-making and fiscal behavior could indeed nullify the potential advantages that fiscal decentralization is supposed to bring by diversifying outputs of the public sector.

What are the main effects of the practice of fiscal federalism on the policy-making behavior of the public sector? There are important mechanisms by which the practice of fiscal federalism affects the aggregate behavior and performance of the public sector in the national economy. In this respect, we address three main areas of possible implications. The first issue is related to the impact of fiscal federalism in influencing the fiscal discipline of the public sector. As we have already observed in the previous sections, the fiscal aggregates of the general government exhibit both continuity and innovation. Despite the reform policies, the government is still running persistent and unsustainable fiscal deficit. The fact that the main driving force behind the deficits is the burgeoning recurrent expenditure suggests that there is no clear turn in the policy stance of the government. The effect of fiscal decentralization on the expenditure behavior of both the federal and the regional governments has been to expand government expenditure, especially recurrent component of expenditure. The increased execution of public expenditure by the regional government is one important aspect, and a potential source of efficiency, in the exercise of fiscal decision-making power. However, this should be accompanied by reorientation and reduction in federal expenditure so that the consolidated government expenditure is in line with revenue and economic growth path of the country.

The second impact is related to public resource allocation behavior. There were important shifts in emphasis in the allocation of public resources. As figure 2 portrays, the most important shift was the reorientation of public expenditure from defense related expenditure to social and economic development expenditures. Expenditure reorientation towards health and education sectors improved not only the efficiency

public resource allocation but also allowed the exercise of overall fiscal discipline. It was possible to improve the fiscal balance and at the same time to increase the share of capital and social sector expenditure. The practice of fiscal federalism contributed positively in the process since the sub-national governments allocated an important share of their budgets for poverty and social development oriented activities. This encouraging development could not continue due to the shift in the policy stance of the federal government. The main victims of such a policy shift were the health, education and other social sectors and capital projects with dampening effect on the performance of the national economy.

The third element of policy interest is how the behavior of the public sector and the practice of fiscal federalism affected the overall performance of the economy and the behavior of other economic agents in the system. The reorientation of the activities of the public sector in areas in which normally the private sector is reluctant to operate or where market failure is predominant would have a crowding-in effect on the private sector and the degree to which the economy can realize its potentials. The fiscal performance of the government can improve the growth and tax-paying capacity of the private sector by allocating resources to activities that have public goods characters and also address the provision of core infrastructure to the private sector. There were important shifts in the policy stance of the government from a policy that categorically discourages the private sector to that, at least nominally, encourages and acknowledges the role of the private sector in the economy. There were important policy measures that opened space for private sector participation in various areas of economic activities. However, there are still considerable ways to go before the policy environment is conducive enough for private sector development.

The introduction of fiscal decentralization has had mixed effects on the participation of the private sector in economic activities. The practice, accompanied by the underlying tone of ethnic federalism, has introduced a political risk factor in the investment decision-making. There is still a tendency of the private sector to avoid long-term investment activities in which routine interaction with political decision-makers and hence interference is unavoidable. Moreover, there are factors that encourage expansion of public sector consumption expenditure at the expense of capital accumulation and hence jeopardizing the sustainability of economic growth. It is therefore clear that despite the overall improvement in the policy environment in which the private sector operates and the attempts by the government to reorient its

expenditure, the public sector and its recurrent consumption behavior has resulted in the relative expansion of public sector consumption in the economy, allowed the predominance of a large and yet inefficient government sector in the economy, that has hampered the resource allocation efficiency and sustainability of growth in the economy.

5. Concluding Remarks

Ethiopia has introduced a unique form of fiscal federalism in the context of ethnic federalism. The process is still in progress that decentralization of fiscal decision-making power has not yet effectively reached the basic unit of administration in the federal structure. The system hence effectively has a two-tier structure of fiscal federalism: the federal government and the regional states. The regional governments have been constitutionally vested with extensive decision-making power. However, the fact that the federal government still centralizes the fiscal means of executing fiscal responsibilities indicates that there is a de facto centralization of fiscal decision-making. This is reflected by excessive dependence of regional governments on federal grants to finance even recurrent expenditures within their jurisdictions. The fiscal system is characterized by both vertical and horizontal imbalances that require further decentralization of revenue sources that commensurate the expenditure responsibilities of the regional governments. This aspect of actual centralization in fiscal relations is accompanied by a parallel structure of political centralization that robs the very inspiration of the process of decentralization.

The practice of fiscal decentralization in Ethiopia, and the political and economic environment in which it operates, has so far failed to improve the efficiency of the public sector by diversifying output and tailoring it to the preferences of the local population. Moreover, centralization of fiscal decision-making is exercised not only at the federal level but also at regional government level. Given the prevailing vertical imbalance, the system has not internalized the cost of their expenditure decisions by regions. This in turn tends to give incentive to expansionary fiscal policy stance and bigger government that might not necessarily translate into strong and effective government. When such practices prevail, the cost of regional and federal fiscal decisions would be born by economic agents and the economy. It is such a policy stance that erodes its sustainability, allows the breach of fiscal discipline, and in the process discourages the realization of whatever potentials available in the private sector, market

forces, and the national economy. It is therefore important that the practice of fiscal federalism in Ethiopia be reoriented to achieve fiscal discipline, selective intervention to stimulate economic activities and diversify public outputs at the local levels to reflect local priorities and address core economic, social and political problems of the country.

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AnnexTable1 -Ethiopia: Profile of regional income and poverty indicators

Regional state	Real Expenditure (Income) per capita (Birr)		Poverty headcount index (Po)	
	1995/96	1999/00	1995/96	1999/00
Tigray	935	854	0.56	0.61
Afar	1595	1178	0.33	0.56
Amhara	961	1088	0.54	0.42
Oromiya	1216	1055	0.34	0.40
Somalie	1268	1211	0.31	0.38
Bensha-Gumuz	1064	965	0.40	0.54
SNNPR	962	962	0.56	0.51
Gambela	1280	981	0.34	0.51
Harari	1599	1370	0.22	0.26
Addis Ababa	1560	1701	0.30	0.36
Dire Dawa	1259	1275	0.29	0.33
Total	1088	1057	0.46	0.44

Source: Ministry of Finance and Economic Development, Addis Ababa, Ethiopia and FDRE 2002.

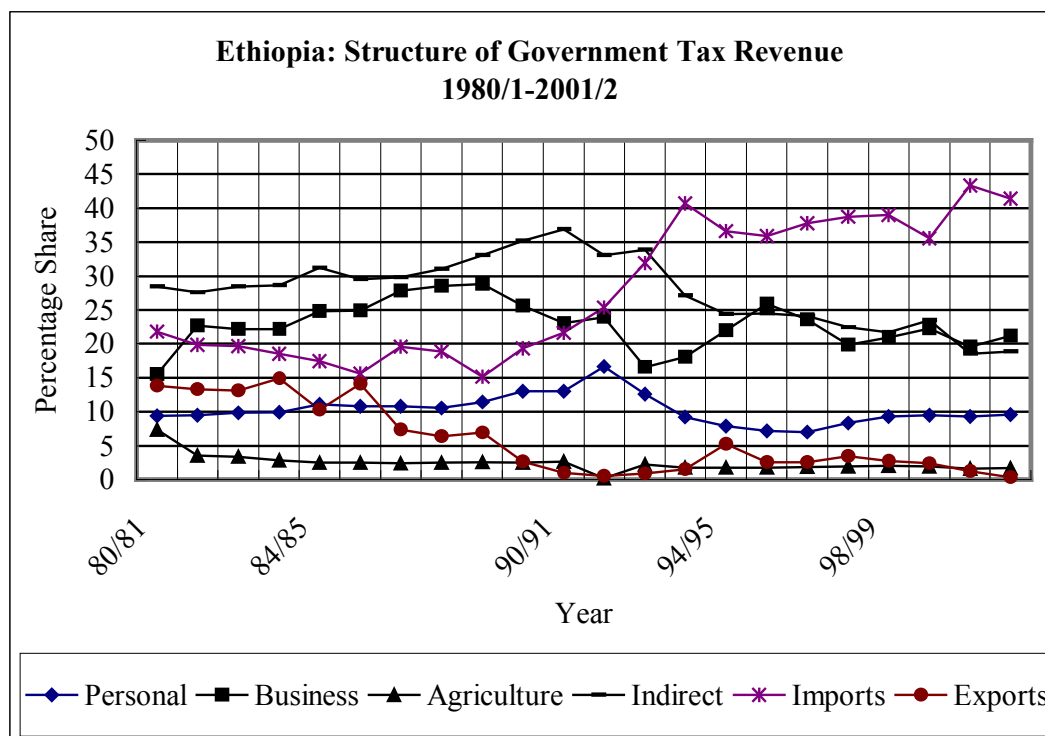


Figure 1: Ethiopia: Structure of Tax Revenue The structure of tax revenue has changed considerably over the last two decades. The government is increasingly becoming dependent on taxes from international trade and especially taxes on imports. The devaluation of the currency in 1993 and the subsequent depreciation has resulted in the expansion of the tax base even if the actual volume and hard

currency denominated amount of transaction has not grown as fast. The impact was so significant that even with reductions in the rate of import duty and transaction tax, the overall tax revenue generation has shown significant increment. For 1991/92 to 2001/02, the share of taxes on imports in total tax revenue collection was about 37 percent.

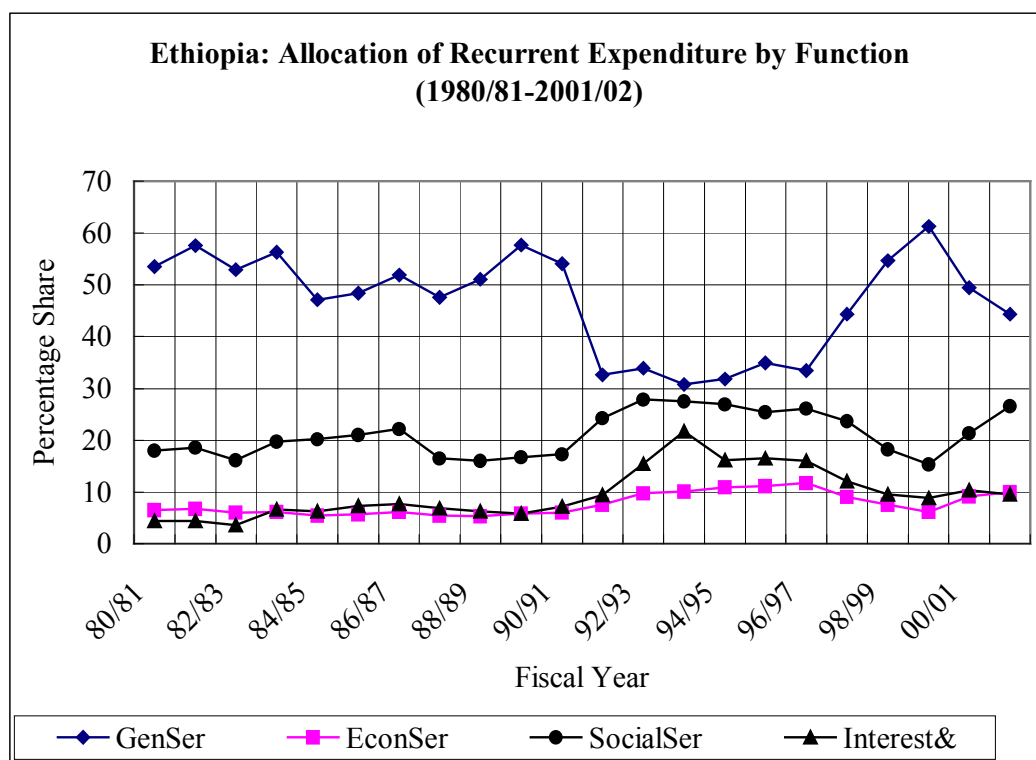


Figure 2: Ethiopia: Allocation of Recurrent Expenditure by Function (1980/81 – 2001/02). The allocation to general services has been dominated by the absorption of budgetary resources to defense expenditure that in turn influenced the overall allocation pattern of public resources. The budgetary allocation of the government to economic services, the main target for crowding out effect of defense related expenditure, is almost equal to the allocation for servicing the debt obligations of the government.